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Report to the Chairman, Committee on Governmental Affairs, U.S. Senate

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CONTRACT PRICING

DOD's Use of the Truth in Negotiations Act Deterrents Could Be Increased

GAO/NSIAD-94-7

GAO

United States
General Accounting Office
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National Security and
International Affairs Division

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October 25, 1993

The Honorable John Glenn
Chairman, Committee on Governmental
Affairs
United States Senate

Dear Mr. Chairman:

This report is issued in response to your request that we evaluate the adequacy of controls for preventing fraud, waste, and mismanagement in Department of Defense (DOD) contract pricing. It addresses DOD's use of the deterrent features offered by the Truth in Negotiations Act, which is intended to ensure fair and reasonable prices in negotiated contracts. To enhance deterrence, we recommend the Secretary of Defense improve oversight and management and more fully implement the act's interest and penalty provisions.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies of this report to the Chairman, House Committee on Government Operations; Secretary of Defense; Directors, Defense Contract Audit Agency and Office of Management and Budget; DOD Inspector General; and other interested parties upon request.

Please contact me on (202) 512-4587 if you have any questions concerning this report. Major contributors to this report are listed in appendix I.

Sincerely yours,

David E. Cooper
Director, Acquisition Policy,
Technology, and Competitiveness Issues

Executive Summary

Purpose

A key safeguard intended to ensure fair and reasonable prices in negotiating contract actions averaging over $65 billion annually is the Truth in Negotiations Act (10 U.S.C. 2306a). Under this act, the government can recover defective pricing that results when contractors or subcontractors do not provide accurate, complete, and current data during contract negotiations. As of March 31, 1993, about $1.8 billion in defective pricing identified in Defense Contract Audit Agency audits was pending against Department of Defense (DOD) contractors.

This report, done at the request of the Chairman, Senate Committee on Governmental Affairs, addresses DOD's use of the act's deterrent features. Specifically, GAO reviewed DOD's settlement of audit findings, interest charges on overpayments, and penalties assessed. In addition, GAO reviewed DOD's management oversight of the settlement process.

Background

Recognizing the government's vulnerability in noncompetitive contracting situations, the Congress passed the Truth in Negotiations Act in 1962 to protect against inflated price estimates. It requires contractors and subcontractors to submit cost or pricing data for their proposed prices above certain thresholds and to certify that the data submitted are accurate, complete, and current. If the data are found to be defective (not accurate, complete, or current), the government can reduce the contract price.

Although the act has been instrumental in providing data needed to negotiate contracts, defective pricing is a persistent problem and adds hundreds of millions of dollars to contract prices each year. Initially, contracting officers could only recover the amount determined to be defective. In 1985, to enhance contractor compliance and improve timeliness of repayments, the Congress added provisions for (1) charging interest from the date of overpayment until repayment and (2) assessing a penalty when contractors knowingly submit defective data.

Results in Brief

DOD has not recovered most of the defective pricing identified by audit primarily because contracting officers (1) dismiss audits for errors, inconclusive evidence, and lack of reliance on the defective data during negotiations and (2) negotiate with contractors and settle for lesser amounts. In addition, interest on overpayments has not been fully charged in all instances, and the penalty has not been assessed.

Further, settlements of defective pricing cases were not timely and involved a lengthy process with administrative burdens on both the government and contractors. DOD's tracking and reporting system was inaccurate, and it lacked information needed for oversight and management of the settlement process.

These conditions diminish the deterrence that is needed for contractors and subcontractors to undertake needed efforts to ensure compliance with the act. Without adequate deterrence, contractors do not have an incentive to eliminate inflated price estimates and correct systemic pricing problems. In addition, the costly and burdensome process of identifying and settling defective pricing by the government and contractors will likely continue.

Principal Findings

Most Defective Pricing Not Sustained

DOD has reported that for audits settled in 1992, about 40 percent of the $239 million in recommended price adjustments was sustained. The sustention rate (the amount contracting officers recover divided by the amount reported in audits) has declined since fiscal year 1988.

Data on selected audits reported closed in fiscal year 1991 show that defective pricing audits were dismissed or amounts recoverable were reduced because contracting officers determined that the audit data did not support defective pricing determinations or were inconclusive. Also, contracting officers, to reach a fair and reasonable settlement and avoid litigation, negotiated with contractors for amounts lower than the recommended price adjustments. In some cases, available documentation supported contracting officers' concerns about audit quality; in others, the documentation raised questions about the contracting officers' determinations.

In 1992, actions to improve the quality of audits were implemented, and some contracting activities initiated efforts to raise sustention rates. In the first half of fiscal year 1993, the sustention rate increased to 57 percent. DOD has not determined whether this increase is attributable to specific 1992 actions or an indicator of a longer term change in sustention rates.

Interest and Penalty Not Fully Utilized

DOD is not fully recovering interest on overpayments. In some cases, contracting officers did not charge interest on overpayments or accepted reduced interest charges. For example, to settle an audit that recommended a price adjustment of $2.8 million plus interest, the contracting officer reduced a follow-on contract by $1.2 million and charged no interest. In addition, the procurement regulations restrict the potential amount of interest because the regulations specifically exclude interest on financing payments, although such payments may include overpayments.

GAO did not find an instance where a contracting officer assessed the penalty. DOD is also not aware of any instance where a contracting officer assessed a penalty. Contracting officers, as well as other DOD officials, apparently view a penalty for a contractor that has knowingly submitted defective data as being tantamount to civil or criminal fraud, which is pursued by the Department of Justice.

Settlements Are Untimely and Burdensome

Although DOD regulations state that audits should be settled in a timely manner, only half of the audits closed in fiscal year 1991 were settled within 1 year of the audit report date. Many of the other settlements took from 2 to 4 years, with some taking longer. This period is based on the issue date of the latest audit report on a defective pricing case. Because settlements often require several reports, the period is significantly increased if measured from the first audit report.

Settlement documents demonstrate that the process was burdensome on both the contractor and DOD. In the selected cases reviewed, most of the settlements involved several audits and responses by contractors, as well as several meetings to resolve issues and reach agreement. Even a relatively simple case was burdensome and took several years to settle. For example, DOD did not recover $3.1 million in defective pricing until 3-1/2 years after a voluntary disclosure by the contractor.

Management System Inadequate

GAO found that the contract audit follow-up system contained numerous reporting errors and did not report needed management data. Overall, the errors identified in the contract audit follow-up system raise questions about the amount of defective pricing being pursued as well as the amount sustained. Also, such management data as the amount recovered from a contractor, interest charged, penalty assessed, or cause for nonsustention are not collected in the system.

The DOD Inspector General has also reported that the system lacks internal controls needed to ensure accurate reporting. Actions are underway to improve reporting in the system.

Recommendations

GAO believes that more effective use of the act's deterrent features will improve contractor compliance. To further enhance deterrence, GAO recommends the Secretary initiate action to more effectively implement the interest and penalty features of the act. GAO provides several actions in chapter 3 for the Secretary's consideration. Although DOD is taking actions to improve the quality of audits and to strengthen settlement review and approval procedures, the contract audit follow-up system should provide accurate and comprehensive data for management assessments and actions. Therefore, GAO also recommends that the Secretary of Defense ensure that the audit follow-up system contains the data needed for oversight and management of the settlement process and that ongoing improvements to internal controls place high priority on providing complete and accurate data.

Agency Comments

DOD generally concurred with this report. DOD agreed with the recommendations that additional actions need to be taken to ensure (1) compliance with the interest and penalty provisions of the Truth in Negotiations Act and (2) the contract audit follow-up system contains accurate and complete data that meets management's needs. DOD did not agree with some specific suggested improvements to the follow-up system.

DOD's comments have been included in the report as appropriate and are presented in their entirety in appendix I.

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Abbreviations

DCAA	Defense Contract Audit Agency
DOD	Department of Defense
IG	Inspector General

Introduction

The Truth in Negotiations Act (10 U.S.C. 2306a) mandates that, in the absence of adequate price competition, prime contractors and subcontractors must provide cost or pricing data when negotiating for contracts. The purpose is to provide a factual basis for the government to negotiate a fair and reasonable contract price. About $65 billion in prime contract awards were negotiated annually by the Department of Defense (DOD) under the provisions of this act for fiscal years 1988 through 1992.

Contractors and subcontractors are required to certify that the cost or pricing data they provide are accurate, current, and complete at the time of price agreement (sometimes called the "handshake date") with the government. If the contracting officer finds that contractors submit inaccurate, incomplete, or noncurrent data that cause the contract price to be overstated, the data are considered defective, and the government can reduce the contract price.

Until 1985, recovery of defective pricing was the only deterrent feature of the act. In response to reports of contractor abuses, the Congress added a penalty equal to the amount of overpayment, if the contractor knew data were defective, and an interest charge on the amount overpaid from the date of overpayment to repayment. The penalty was to provide an incentive for contractor compliance, and the interest charge was to recover for the contractor's use of money involved in the overpayment.

Responsibilities Shared Within DOD for Defective Pricing

Oversight, management, and settlement of defective pricing is shared within DOD. Contract audits, settlements of defective pricing, and management and oversight are the responsibilities of the Defense Contract Audit Agency (DCAA), DOD acquisition and contract administration activities, and the DOD Inspector General (IG).

DCAA performs contract audits and provides accounting and financial information on contracts and subcontracts to DOD acquisition and contract administration personnel. As part of its responsibilities, DCAA audits contracts to determine if contractors have submitted defective data to contracting officers during negotiations. Although contracting activities can request an audit, DCAA's program of audits is independently managed. Defective pricing audits with recommended price adjustments for defective data are advisory.

Contracting officers within acquisition and contract administration offices are responsible for settling DCAA defective pricing audits. In settling

defective pricing audits, contracting officers are required to give full consideration to the audit findings but have ultimate responsibility for determining whether the data submitted were defective and relied upon during contract negotiations. Also, the contracting officer is to allow an offset against the amount of defective pricing if a contractor can show that defective data were submitted that understated the contractor's costs. Before making a determination on the amount to be recovered, the contracting officer should work with DCAA and give the contractor an opportunity to support the accuracy, completeness, and currency of the data in question. Also, DOD's policy on contract audit follow-up requires contracting officers to seek the advice of specialists in audit, law, and other fields. When a final determination is made, the contracting officer is to notify the contractor. If the contractor does not concur or fails to respond in a timely manner, the contracting officer has the right to issue a unilateral decision. As with any other contract action, contracting officers are required to document the determinations and settlements of defective pricing audits.

Secretaries of the military departments and directors of defense agencies are to (1) establish procedures as prescribed by acquisition regulations that contracting officers are to use for settling contract audits, (2) ensure proper settlement of contract audits, (3) submit contract audit status reports, and (4) maintain an adequate follow-up system. In addition, they are required to designate an official to manage the component's contract audit follow-up program.

DOD IG is responsible for overseeing DCAA contract audit activities as well as DOD's contract audit follow-up programs. As part of these responsibilities, DOD IG evaluates DCAA's compliance with audit standards, policies, and procedures. In addition, it monitors, coordinates, and evaluates DOD's contract audit follow-up system. Although DOD IG has audit policy responsibility and oversees contract audits and settlements, it does not have the authority to direct DCAA activities or contracting officer actions.

Contract Audit Settlement Reporting

DOD's management tool for tracking and reporting on contract audit settlements is the audit follow-up system required by DOD Directive 7640.2. This system is also the source of information for DOD IG's Semiannual Report to the Congress. The purpose and operation of DOD's contract audit follow-up system is specified in Office of Management and Budget Circular No. A-50. Defective pricing is 1 of 14 types of audits reported in the

follow-up system. As of March 31, 1993, about 900 reports, detailing about $1.8 billion of DCAA-identified defective pricing, were being tracked.

The follow-up system tracks individual defective pricing audit reports by the DCAA report number. DCAA provides summary sheets and control logs on the audit reports that contracting and contract administration organizations are responsible for settling. Acquisition and contract administration organizations are required to prepare and submit reports semiannually on the status of these reports for inclusion in the system. The system reports on the number of audit reports issued and closed during the period, the amount of cost questioned and the amount sustained, and, to some extent, the age of the audit report.

The sustention rate for defective pricing audits is calculated from information in the follow-up system and is used in management and oversight of the settlement process. The rate is determined by dividing the total amount of cost sustained by contracting officers during the period by the total amount of cost questioned by DCAA in the reports settled. Semiannually, DOD IG reports sustention rates of major acquisition activities and recommends corrective action if rates are too low.

In addition to the DOD contract audit follow-up system, DCAA maintains its own automated field office management information system for assignment management purposes. This system contains information on the contract dollars audited for defective pricing, the recommended price adjustment in completed audits, and contracting officer settlements. DOD IG's Semiannual Report to the Congress includes information from this system.

Objective, Scope, and Methodology

Our objective was to examine DOD's use of the deterrent features of the Truth in Negotiations Act. Specifically, we reviewed DOD's settlement of audit findings, interest charges on overpayments, and penalties assessed for a "knowing" violation. In addition, we reviewed DOD's management oversight of the defective pricing audit settlement process.

We evaluated selected cases of defective pricing audits reported settled in fiscal year 1991. From DOD's contract audit follow-up system, we selected audits that had at least $1 million in defective pricing sustained or were closed with no amount sustained but had at least $1 million in recommended price adjustments. We also selected from DCAA's management information system audit reports that had at least $500,000 in

defective pricing sustained or were closed with no amount sustained but at least $1 million in recommended price adjustments. Because 11 of the 98 cases were duplicate, our selection provided 87 distinct defective pricing contract audit reports. While the number of reports selected is about 10 percent of the reports closed in the fiscal year, the reports account for about 50 percent of the dollar amounts reported in the two systems. Because the analysis was based on a judgmental selection of contract audits, the results cannot be projected.

Our analysis of contract audit settlements was based on documented contracting officer determinations. For the selected cases, we obtained price negotiation memorandums, contract modifications, and other documents that support contracting officers' determinations and settlements. Our objective did not include identifying the underlying causes for amounts not sustained, an additional step that would have required more detailed analyses. Furthermore, we did not receive all of the settlement documentation for 20 of the audit reports selected because they were withdrawn by DCAA, not settled, in litigation, or documentation was not provided. As a result, our analysis on settlements is based on 67 contract audits—35 from the DOD follow-up system and 32 from the DCAA management system.

We had discussions with acquisition officials in the Army, Navy, and Air Force on the implementation of the act's deterrent features and obtained disposition documents for selected contract audits. We also discussed the results of our review with DCAA, DOD IG, and designated acquisition, contract administration, and contract audit follow-up officials.

We reviewed the legislative background of the Truth in Negotiations Act and the implementing policies and regulations. We reviewed the Defense Acquisition Regulatory Council's case file on inclusion of the interest and penalty provisions in the acquisition regulations. We obtained and reviewed DOD IG's oversight evaluations of (1) DCAA defective pricing audits and (2) DOD's follow-up of defective pricing audit settlements.

Our review was done between January 1992 and March 1993 in accordance with generally accepted government auditing standards. DOD provided written comments on a draft of this report, which are included in their entirety in appendix I.

Most Identified Defective Pricing Not Sustained

For the defective pricing audit reports settled during fiscal year 1992, DOD reported that 40 percent of the $239 million in recommended price adjustments was sustained. Since 1988, this annual rate has declined. Most of the identified defective pricing from our selected audit reports that was not sustained was primarily because contracting officers (1) dismissed the audit report or reduced the amount for inadequate support and (2) negotiated with contractors for "fair and reasonable" settlements. DCAA and some contracting activities have taken specific steps to improve sustention rates.

Sustention Rate Has Declined

For fiscal year 1992 settlements, DOD reported that 40 percent of the DCAA-recommended price adjustments was sustained. DOD officials said that an acceptable sustention rate has not been established because contracting activities could engage in inappropriate actions to achieve an arbitrary goal. These officials said that instead of examining an overall sustention rate, which they believe is not very meaningful, DOD IG regularly reviews sustention rates for individual buying commands and reviews selected actions by contracting officers in detail. Although some acquisition activities have attained relatively high rates for a period of time, DOD's overall rate has declined since 1988. Table 2.1 summarizes DOD's reported sustention rates for fiscal years 1988 through 1992. However, as discussed in chapter 4, both our work and DOD IG reports have identified errors in the reporting system that raise questions about the amounts reported as cost questioned and cost sustained.

Table 2.1: Identified Defective Pricing Sustained in Fiscal Years 1988 to 1992 Settlements

Dollars in millions

Fiscal year	Cost questioned	Cost sustained	Sustained rate (percent)
1988	$587.3	$284.7	49
1989	374.4	176.4	47
1990	416.9	196.4	47
1991	226.6	93.0	41
1992	238.6	95.2	40
Total	**$1,843.8**	**$845.7**	**46**

For the first half of fiscal year 1993, the sustention rate increased to 57 percent. DOD has not determined whether this increase is attributable to specific actions or is an indicator of a longer term change in sustention rates. One specific action taken in 1992 was a DCAA effort to improve outstanding audit reports with recommended price adjustments over

$1 million. Field audit offices were directed to review all such reports by June 1992 to ensure that defective pricing existed and that the workpapers contained sufficient support for the findings. DCAA reported that the audit offices reviewed over 1,000 reports and reduced recommended price adjustments in 146 reports by $169 million. Such reductions would result in higher sustention rates as these reports are settled.

DOD officials said that other actions by the military services and DCAA should also improve sustention rates. They noted that (1) the military services had established dedicated settlement activities and increased management attention to individual settlements where the sustention rate is less than 50 percent and (2) DCAA had taken actions that should result in better documented defective pricing recommendations.

Audit Errors, Inconclusive Evidence, and Lack of Reliance Lower Sustention Rate

We found that the recommended price adjustments were often not sustained because contracting officers determined that the audit reports had errors or contained facts that were inconclusive, or contracting officers did not rely on the defective data when negotiating the contracts. DCAA also identified similar problems with the defective pricing audits and undertook significant efforts in 1992 to improve the quality.

Of the 67 audit report settlements in fiscal year 1991 that we reviewed, 29 audits were closed for no amount sustained or the amount was reduced because the contracting officer determined that the DCAA audit report was in error or the facts did not conclusively support the recommended price adjustment. For example, the Navy awarded a $103-million contract for the fabrication, testing, and delivery of training equipment. DCAA reported in August 1990 that the prime contractor had pricing information from major subcontractors prior to the certification date of February 1, 1988, that was not disclosed to the contracting officer during negotiations. DCAA recommended a price adjustment of $5.3 million. The contracting officer determined that price agreement, the "hand-shake date," was on January 11, 1988, about 3 weeks before the contractor's certification date, and that the contractor did not have the pricing data prior to that date. As a result, the contracting officer dismissed the audit report because the report did not use the price agreement date and the contractor was not required to disclose cost or pricing data developed after price agreement.

In another case, the Navy reduced a significant portion of a DCAA-recommended price adjustment because government records did not have sufficient data to counter the contractor's claim that subcontract pricing

data were disclosed at time of negotiation. DCAA recommended a $5.1-million price adjustment primarily because the prime contractor did not disclose an updated proposal from a subcontractor. The contracting officer noted that the prime contractor had information from its negotiator's notebook that showed data from the updated proposal were discussed during negotiation. DCAA's evidence was inconclusive because government records or other data did not exist to show that data from the updated proposal were not disclosed during negotiations.

Audit reports were also dismissed because contracting officers said that they did not rely on the defective data during contract negotiations. For example, DOD awarded a contract in 1988 for over $3 billion to manage a civilian health care program. A DCAA report, issued in August 1989, recommended a price adjustment of over $21 million because the contractor (1) did not disclose its practice of proposing salaries and other costs that were higher than actual and (2) included proposed costs that were specifically unallowable under federal procurement regulations. The contracting officer noted that the data submitted by the contractor at the time of negotiations were known to be inaccurate, incomplete, and not current. Also, the contracting officer noted that the contractor submitted additional data during negotiations. The contracting officer determined that the government was not entitled to a price adjustment as recommended by DCAA because the defective data were not relied upon.

DCAA, in its reviews of audit reports and contracting officer determinations, determined that deficiencies in price negotiation memorandums and its reports have contributed to low sustention rates. As a result, DCAA revised the contract audit manual to ensure that audit work and reports support recommended price adjustments for defective pricing and that auditors obtain input directly from the contracting officers and contractors prior to issuing a report, rather than rely solely on information provided in negotiation memorandums. These changes went into effect for fiscal year 1992 audits. Also, as previously discussed, DCAA's field offices were to complete reviews of outstanding audit reports in 1992.

Inappropriate Determinations Lower Sustention Rates

We identified contracting officer determinations that appeared inappropriate because DCAA-recommended price adjustments were reduced or eliminated without an apparently valid basis. One example involved a $1.2-million recommended price adjustment. DCAA reported that a contractor proposed to buy equipment at an estimated cost of $2.5 million, but had developed a $1.3-million estimate to make the item

in-house. Because the lower estimate was not disclosed, DCAA recommended the difference between the two estimates as a price adjustment. The contracting officer dismissed the price adjustment because the audit did not provide evidence that the contractor, at the time of price agreement, had decided to make rather than buy the equipment. This determination is questionable because the act requires contractors to disclose all cost and pricing data that would reasonably be expected to significantly affect price negotiations. The DCAA report did not address whether a decision had been made because the cost estimate to make the item in-house is cost or pricing data that should have been disclosed. The difference in the two estimates is significant and disclosure of the make estimate could have influenced the negotiation and the price.

Another example of a contracting officer determination that appears inappropriate involves disclosure and reliance. The Air Force awarded a $14.7-million contract for supporting equipment on April 29, 1987. In a September 1990 report, DCAA recommended a price adjustment of $1.3 million because the contractor did not disclose the latest cost reports at the time of price agreement. Initially, the contracting officer disagreed with DCAA, noting that the latest cost reports, dated January 1987, were provided. Subsequently, the contracting officer was informed that the cost reports provided during negotiation were dated November and December 1986 and that a handwritten notation on the reports indicated that the contractor provided the reports during the January 1987 negotiations. The contracting officer, however, still dismissed the audit report because actual data were provided and the Air Force met its negotiating objective. This determination appears questionable because the most current cost data, the January 1987 reports, were not provided. Also, according to DOD's guidance, meeting a negotiating objective does not negate the government's right to a price adjustment.

Negotiated Settlements Also Lower Rate

Another reason that contributed to the low sustention rate was that contracting officers negotiated with contractors to reach what they believed were fair and reasonable settlements. Negotiation is a bargaining process that implies the government is willing to reach a mutually satisfactory agreement with the contractor. In defective pricing settlements, negotiations are a means by which contracting officers and the contractors' representatives agree to a lesser price adjustment to avoid administrative costs and litigation.

In the cases we reviewed where the government recovered defective pricing, contracting officers usually negotiated settlements that were lower than the DCAA-recommended price adjustment. For example, DCAA questioned costs of over $500,000 because an updated subcontractor quote was not disclosed to the Navy when negotiating the contract. This amount was part of a defective pricing finding of $3.7 million. The settlement documents noted that neither the government nor the contractor could provide information to verify whether the subcontractor's quote was disclosed during contract negotiations. Although no factual data were present, the Navy and the contractor agreed to "split the difference" as a compromise. This approach was used on another issue in the case when the Navy believed the contractor should indicate some responsibility for defective pricing. The Navy offered to split the questioned cost again, but the contractor countered with a significantly lower offer. Overall, the contract price was reduced by $1.8 million, less than 50 percent of the amount questioned by DCAA.

In another example, the Air Force accepted a contractor's proposed offsets, even though DCAA did not consider them valid. DCAA recommended a $2.9-million price adjustment, and the contractor proposed an offset for almost all the price adjustment. According to the settlement documents, the contracting officer allowed $500,000 as part of a negotiated lump-sum settlement in an effort to reach a fair and reasonable price adjustment. Overall, the government recovered $1.4 million, or about 50 percent, of DCAA's recommended price adjustment.

The government is entitled to a price adjustment for the full amount of the pricing defect as determined by the contracting officer. However, we found cases where the contracting officers, although agreeing with the audit's facts and recommended price adjustment, negotiated for a lesser adjustment to avoid possible litigation. For example, in a June 1988 report, DCAA recommended a price adjustment of $1.3 million because the contractor did not disclose actual labor hours on similar contracts during negotiations. After reviewing the facts and contractor comments, the contracting officer determined the contract was defectively priced and issued a decision in April 1991 for the full amount recommended by DCAA. Subsequently, the contracting officer negotiated a final settlement for $875,000, which was considered to be in the government's best interest "since it eliminates costly litigation that would continue for years."

DOD officials said that contracting officers, with the assistance of legal counsel, must weigh the risks and benefits of litigation to determine

whether a negotiated settlement is in the government's best interest. They noted that defective pricing cases are often complex and contracting officers are required to use judgments in making prudent business decisions.

Causes for Nonsustention Identified by DOD IG

The causes that we identified for DCAA's recommended price adjustments not being sustained are similar to those identified by DOD IG in its October 1990 report on nonsustention of questioned costs.[1] DOD IG reviewed 121 defective pricing audit reports closed during fiscal years 1987 and 1988. The actual sustention rate for the sampled defective pricing audit reports was 48 percent. Some of the causes that it identified for nonsustention were the following:

- Contracting officers said that they did not rely on defective data when negotiating the contract price.
- Contracting officers accepted data provided by contractors during negotiations.
- Contract audit reports contained inaccurate or outdated information.
- Legal counsel advised against sustention because the audit issues were not supportable.
- Contracting officers disagreed with the auditor's position.
- Contracting officers agreed to bottom-line settlements because agreement on individual cost elements could not be reached with contractors.

Because of such circumstances as those identified above, DOD IG concluded that the amounts sustained during its 2-year sample period were reasonable. However, that did not mean the rate could not be improved upon as DOD IG recommended that acquisition activities (1) adhere to required review and clearance procedures to ensure that contracting officer determinations are fully supported and (2) analyze settlement data to identify major factors affecting sustention performance.

Some acquisition activities have responded to DOD IG's recommendations. For example, the Navy initiated a 10-point program to identify those circumstances that impede a healthy sustention rate. The program requires such actions as establishing dedicated settlement activities, "top-level" explanations for poor sustention performance, and training for contract audit follow-up personnel. The Army conducted an in-depth review of closed audit reports to identify factors that affect sustention rates. Some

[1]Analysis of Nonsustention of Costs Questioned in Postaward Contract Audit Reports (Report No. AFU91-1, Oct. 11, 1990).

of the Army commands that participated in the review noted that dedicated settlement activities would be established and that more training for contract audit monitors would be requested. DOD officials said that the Air Force reviews defective pricing settlements where sustention rates are less than 50 percent or the difference between costs questioned and sustained is greater than $1 million.

DOD IG officials told us that settlement of contract audit issues such as defective pricing are often accorded lower priority at DOD buying activities because of the pressure of new business. As a result, they said that timely and effective processing of defective pricing audits requires management support and assignment of priority, as well as monitoring by DOD IG staff.

Interest and Penalty Provisions Not Fully Utilized

The Congress added interest and penalty provisions to the Truth in Negotiations Act in 1985 because, under the original legislation, contractors had little incentive to (1) submit accurate, complete, and current data and (2) expedite settlement. However, DOD has not fully utilized these provisions to provide the enhanced deterrence the Congress envisioned. DOD regulations do not provide for collecting the maximum interest, and contracting officers, acting without specific authority, have not charged part or all the interest due on overpayments. The regulations provide no guidance on assessing the penalty, and DOD officials know of no instance where the penalty has been assessed. When a contract is defectively priced and DOD does not effectively use the act's provisions, the deterrent effect is diminished.

Interest and Penalty Enacted to Deter Contractor Offenses

In response to continuing reports of contractor offenses, the Congress enacted interest and penalty provisions to help deter violations of the Truth in Negotiations Act. In hearings before the Senate Committee on Governmental Affairs in early 1983 and the House Committee on Government Operations in 1985, witnesses and committee members discussed the act's inadequate deterrence. No penalty existed for overpricing, and interest accrued only if the overpayment was not paid within 30 days from a government demand for payment. Committee members and some witnesses noted that contractors had little incentive to submit accurate, complete, and current data and that the government lacked a real deterrent to contractors' defective pricing violations. One witness noted that contractors who received overpayments because of defective data had long-term use of government funds and paid no interest, an inherent weakness in the original legislation. Members and witnesses stated that collecting interest from the date of overpayment would provide an incentive to settle and establishing a penalty would (1) provide the incentive for contractors to fully furnish satisfactory cost and pricing data and (2) deter contractors from committing pricing violations.

In the DOD Authorization Act for fiscal year 1986, the Congress added interest and penalty provisions to the Truth in Negotiations Act. These provisions state that if an overpayment is because a contractor submits defective data, the contractor shall be liable "for interest on the amount of such overpayment to be computed from the date the payment was made to the contractor to the date the Government is repaid by the contractor at the applicable rate . . ." and "if the submission of such inaccurate,

incomplete, or noncurrent cost and pricing data were a knowing submission, an amount equal to the amount of the overpayment."

Full Amount of Interest Not Collected

DOD could recover more interest on overpayments. In 7 of 10 cases we reviewed where interest was applicable,[1] we found that contracting officers did not charge interest as specified in the regulations. In addition, the law states that interest shall be computed from the date payment was made to the date of repayment. Although progress payments made by the government can result in overpayment, the acquisition regulations specifically state that these progress payments are to be excluded from the amount of overpayment when calculating interest. With about $1.8 billion in defective pricing outstanding as of March 31, 1993, millions of dollars in additional interest could be due on future settlements, even if sustention rates remain around 40 percent.

Settlements Result in Interest Not Being Fully Charged

In some of the cases we reviewed, contracting officers did not charge interest as required by acquisition regulations. The Truth in Negotiations Act states that contractors shall be liable to the United States for interest on overpayments. The regulations instruct contracting officers that the government is entitled to interest on any overpayments due to defective pricing, and contracting officers are to include in their price reduction modification or demand for payment the amount of interest due through a specified date. The regulations give contracting officers no specific authority to waive part or all of the interest due. The following cases illustrate the treatment of interest in settlements we reviewed.

A Navy contracting officer responsible for settling defective pricing cases told us that four cases for over $400,000 were closed with bottom-line settlements to avoid litigation. The contracting officer considered the cases weak and believed the dollar amount was too small to justify the anticipated legal and administrative costs. Settlement documents do not show that interest was collected on the overpayments. However, in a letter to us explaining why the settlement documents did not show interest as being collected, the contracting officer cited difficulty in determining what percentage of funds recovered in a bottom-line settlement represents interest.

[1]The provision for interest to accrue from the time of overpayment became effective in November 1985. Most of our selected defective pricing cases involved contracts awarded prior to this date.

In a case where the contracting officer and contractor had difficulty agreeing on the price adjustment, interest did not become a factor. DCAA recommended a $2.8-million price adjustment for defective pricing in February 1988 on an $81-million contract. The contractor strongly disagreed that any defective pricing existed, objected even to issuance of such a report, and was unwilling to offer any money to settle the case. Finally, after several failed attempts by the contracting officer to settle the defective pricing case, the contractor, while denying any defective pricing, agreed to a Navy suggestion to resolve the matter by reducing a follow-on contract by $1.2 million. Although interest was due on the overpayment, no interest was charged.

In another case, a contracting officer, believing the offset to be invalid, rejected a contractor's request for an offset to the defective price amount. However, believing some consideration was in order, the contracting officer allowed the offset of $72,000 to be applied against the $154,916 in interest, thereby reducing the amount of interest collected.

In some cases where interest was considered, documentation indicates that interest might not be an addition to the overpayment, but an adjustment to a bottom-line settlement. In one such case, DCAA identified defective pricing of $1.6 million. The contracting officer's negotiation objective was an adjustment of $1.3 million plus $178,000 in interest. The negotiated settlement concluded on a bottom-line basis for slightly over $1 million. Although the negotiation memorandum for this settlement cites amounts for overpricing and interest, the interest was calculated as an adjustment to a bottom-line settlement, not an addition to the determined overpayment.

DOD and service regulations, which provide specific review and approval procedures for clearance of contract actions by acquisition activities, do not provide for specific checks to ensure that contracting officers charge interest properly. At the acquisition activity, business clearances that document defective pricing settlements are approved even when the contracting officer has not specified any interest recovery. Officials reviewing settlements at the designated contract audit follow-up level cannot determine if interest charges are correct because interest is not a reported item.

Regulations Do Not Maximize Interest

DOD regulations do not provide for the maximum amount of interest. Federal Acquisition Regulation part 15.804-7 defines the date of overpayment as the date payment was made for completed and accepted contract items. The regulations prohibit interest recovery for amounts paid for contract financing. However, the statute, which stipulates interest is to be calculated from the date of overpayment, supports such recovery. In the House hearing cited previously, the DOD Deputy Inspector General stated that interest should accrue from the date of the first progress payment, but only if those progress payments were increased due to defective pricing. Also, the Air Force Staff Judge Advocate commented in June 1989 that the regulation should state that an overpayment may occur whenever an excess payment, including any contract financing payment, is made because the contractor submitted defective cost or pricing data. The Defense Acquisition Regulation Council disagreed, saying there is minimum exposure, if any, of interest applicable to overpayment resulting from contract financing. It further stated that such a calculation would require a large administrative burden, yet the recoverable amount would be small in relation to the administrative costs. However, no documentation was available in the files to substantiate this conclusion. We believe that such a regulatory determination should have been based on a documented analysis of the administrative burdens and possible interest recovery.

In some cases, adding interest to an overpayment occurring in progress payments might not be significant and could be an administrative burden. However, in other cases, interest on overpayments occurring in progress payments could be significant, and interest determinations might not be a costly administrative burden. For example, a prime contractor's request for a progress payment could include costs for items delivered by a subcontractor. If the subcontractor's costs were overstated due to defective pricing, then the prime contractor's request for a progress payment would be overstated. As previously reported, there is significant defective pricing in subcontracts.[2]

Penalty Provision Has Not Been Used

We found no evidence that contracting officers have used the penalty provision in the Truth in Negotiations Act. DOD contracting officers did not use the penalty to settle any of the defective pricing cases we reviewed. Although most of our cases involved contracts awarded before the penalty provision was enacted, the contracting officers that we interviewed stated that they would not consider using the penalty because it is associated

[2]Contract Pricing: Subcontractor Defective Pricing Audits (GAO/NSIAD-91-148FS, Mar. 21, 1991).

with fraudulent acts. Furthermore, officials in DOD IG's contract audit follow-up group who periodically evaluate settlements also told us that they have not seen the penalty used.

The acquisition regulations provide little guidance for implementing the penalty. Part 15.804-7(i) of the Federal Acquisition Regulation says that on DOD contracts only, the government is also entitled to penalty amounts on certain of these overpayments. . . ." Part 15.804-7(iii) is the only guidance for assessing penalties in cases of defective pricing. It reiterates the law and instructs the contracting officer to obtain the advice of counsel.

The non-use of the penalty provision has diminished its deterrent value. The penalty under the act is not used apparently because contracting officers, as well as other DOD officials, view a penalty for a knowing submission of defective data as being tantamount to civil or criminal fraud, which is pursued by the Department of Justice. A 1987 DOD IG memorandum states that any suspected violations that would warrant a penalty should be immediately referred to the defense investigative organization for review and that any contract action should be held in abeyance pending Department of Justice consideration of a criminal investigation.

DOD officials said that if the contracting officer or auditor believes a contractor knowingly submitted defective data and counsel agrees, then the case is referred as false claims/false statements. DOD IG noted that defective pricing cases with civil or criminal fraud implications are beyond the contracting officers' authority to settle and that DOD's contract penalty should not be imposed without the coordination of the Department of Justice. The Department of Justice resolved five of our selected defective pricing cases after initiating action under the False Claims Act.

Need for Penalty Still Exists

The need for a deterrent, which existed when the Congress added the penalty provision to the Truth in Negotiations Act, still remains. The risk of defective pricing still exists, and contractors do not comply with the act. DCAA annually identifies contractors' risk for defective pricing.[3] For fiscal year 1992, DCAA assessed contractors' defective pricing risk based on four factors: estimating system deficiencies, accounting system deficiencies, incidence of defective pricing, and amount of recommended price adjustments. DCAA considered 36 contractors as high risk for estimating

[3]For additional details on DCAA's assessment of "high risk" contractors see, Contract Pricing: DCAA's Methodology Change in Identifying "High Risk" Contractors (GAO/NSIAD-92-183, June 2, 1992).

systems deficiencies, 63 contractors as high risk for incidence of defective pricing, and 17 contractors for the amount of recommended price adjustments for defective pricing. DCAA determined that 96 contractors—a 48-percent increase over fiscal year 1991—were high risk for at least one of the individual factors assessed. Defective pricing involving billions of dollars has been a persistent problem because a low percentage of contractors are not complying with the act.[4] For fiscal years 1987 to 1991, 116 contractors accounted for 86 percent of the $3.7 billion in defective pricing reported by DCAA.

Recommendation

The act's deterrent value has been diminished because DOD has not effectively utilized the interest and penalty provisions. Without adequate deterrence, contractors and subcontractors do not have incentive to eliminate inflated price estimates and correct systemic pricing problems. In addition, the costly and burdensome process of identifying and settling defective pricing by the government and contractors will continue. Therefore, we recommend the Secretary of Defense more effectively implement the interest and penalty features of the act to ensure contractor compliance. More effectively implementing the act could include

- determining, based on an analysis of appropriate defective pricing audit reports, whether charging interest on overpayments in progress payments resulting from defective pricing is administratively feasible and would result in significant interest recovery, and if so, initiating action to revise the regulation;
- directing contracting activities to instruct contracting officers to charge interest as stipulated in the regulations and to include internal control checks for proper interest charges during business clearance reviews; and
- modifying DOD's guidance to instruct contracting officers on the use of the penalty in determining the amount recoverable from contractors for defective pricing.

Agency Comments and Our Evaluation

DOD agreed that additional actions need to be taken to ensure compliance with the interest and penalty provisions of the Truth in Negotiations Act. DOD said that, in assessing the significance and administrative feasibility of interest on overpayments in progress payments, it would use a DCAA study to be conducted by March 1994. Also, contracting activities are to instruct contracting officers to charge interest as stipulated in the regulation and to

[4]Contract Pricing: A Low Percentage of Contractors Are Responsible for Most Reported Defective Pricing (GAO/NSIAD-93-1, Nov. 24, 1992).

include internal control checks for proper interest charges. With regard to the penalty, DOD commented that the Office of General Counsel will be requested to review current regulations on the assessment of penalties as a basis to determine if additional guidance is appropriate.

DOD's proposed actions are appropriate initial steps that could lead to more effective implementation of the interest and penalty features of the act.

Settlement Process Is Burdensome and Management System Is Inadequate

Documents demonstrate that DOD's settlement of defective pricing audits is a time-consuming and burdensome process. Although settling a defective pricing audit within 1 year is generally considered timely, we found the average time was considerably longer, about 2-1/2 years, with many taking as much as 4 years. The settlement process—often involving several audits, detailed responses by contractors, analyses by contracting officers, legal and administrative reviews, and negotiations over a period of months—is administratively burdensome for DOD as well as contractors.

Although responsibility and oversight are well-defined, the contract audit follow-up system is inadequate for effective administration of the settlement process. Overall, the information reported in the system contains numerous errors, which raise questions about the amount of defective pricing being pursued as well as the amount sustained. Also, important information related to the settlement of defective pricing audits such as amounts recovered and causes for nonsustention are not regularly compiled or reported in the contract audit follow-up system.

Many Settlements Are Not Timely

DOD did not settle defective pricing audits in a timely manner. Previous DOD instructions required that contract audits be settled within 1 year; however, to eliminate an arbitrary time limit, the current instruction does not specify a settlement time period. Currently, DOD's instructions classify an audit report as "overaged" if it has not been settled in 12 months from the issue date. In fiscal year 1991, about 50 percent of the defective pricing audits were settled within 1 year from the issue date. Figure 4.1 shows that about 25 percent of the audits took over 2 years to settle, with some taking well over 4 years.

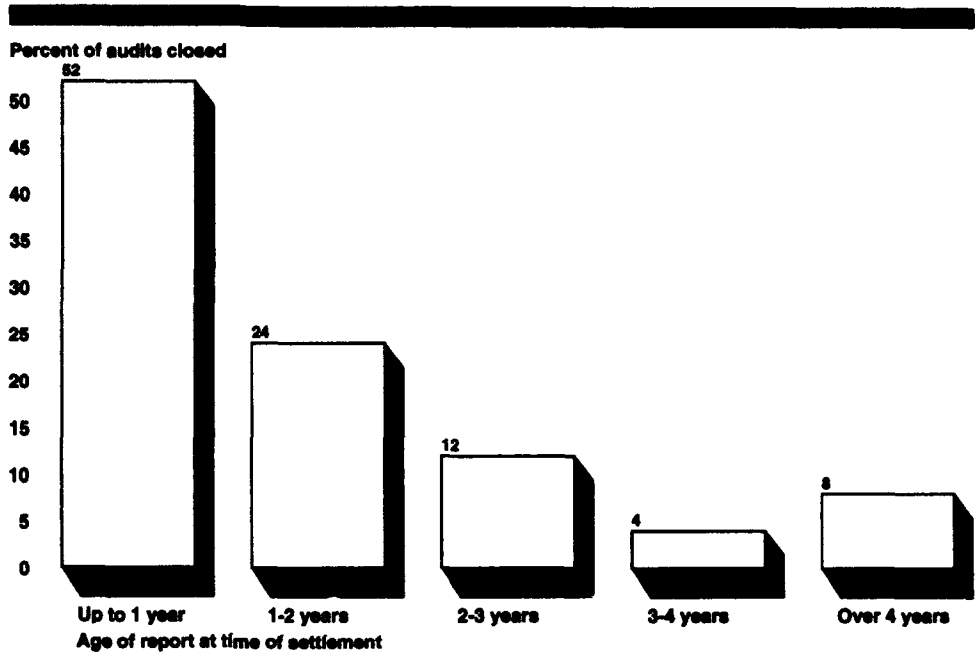

Figure 4.1: Age of Defective Pricing Audit Reports Closed During Fiscal Year 1991

Furthermore, the time period for settlements is tracked from the latest audit report on the defective pricing. Defective pricing settlements may involve several supplemental audits to review contractors' comments, proposed offsets, or subcontracts awarded by the prime contractor. If the time required for settlement is tracked from the initial report rather than the last audit report issued by DCAA, the settlement time would increase significantly. Of our 35 cases selected from the follow-up system, 17 had more than 1 audit. For example, four audit reports on a Navy contract were issued over a 2-year period. The initial report in August 1987 recommended a $3.4-million price adjustment. After DCAA issued an updated report in February 1988, the contractor formally responded in June and August 1988. At the request of the contracting officer, DCAA reviewed the contractor's comments and, in a January 1989 report, increased the recommended price adjustment to $4.5 million. After a further request by the contracting officer, DCAA issued a final report in September 1989, reducing the price adjustment to $3.7 million based on agreements between DCAA and the contracting officer.

The lengthy settlement process has resulted in an outstanding balance as of March 31, 1993, of about $1.8 billion in DCAA-recommended price adjustments for defective data. About 40 percent of this amount has been outstanding since fiscal year 1990, with some cases occurring before fiscal year 1985.

Settlement Process Is Burdensome

Settlement documentation shows that contracting activities and contractors encounter administrative burdens throughout the settlement process. The government has the burden of proof in establishing every element of a contract price reduction for defective pricing. DOD is responsible for documenting what cost and pricing data the government negotiators relied on during price negotiation, discovering defective data in the contractor's records, establishing a legal case for the settlement, and supporting the amount to be recovered. In response, contractors must maintain data supporting their cost and prices, develop a point-by-point rebuttal to DCAA's contract audit findings, and negotiate a final settlement with the contracting officer. To avoid an adverse settlement of the case, contractors can appeal a contracting officer's decision on defective pricing to the Armed Services Board of Contract Appeals or United States Court of Federal Claims. If appealed by the contractor, final resolution will be significantly extended.

The following case indicates the process that can be involved in settling a defective pricing audit. In this example, DCAA, in an audit report dated September 15, 1986, identified over $37 million of defective pricing in a 1982 Army procurement of combat vehicles for $605 million. DCAA reported that the cost and pricing data were defective because the contractor did not disclose the latest quotes for raw material and an updated price proposal with a major subcontractor. The contractor, in a January 1987 response, argued that the quotes for raw material, although available before certification, were not received in time for disclosure to the government and that the subcontractor's updated price proposal was not received until 10 days after certification.

DCAA, at the request of the contracting officer, audited the contractor's response and issued a superseding report on April 29, 1988, reducing its recommended price adjustment to about $35 million. DCAA adjusted for errors but did not accept the contractor's arguments on the two major issues. In fact, DCAA offered more evidence to support its case. Using this information, the contracting officer determined that the contract price was defective, but believed that only about $11 million could be recovered

from the contractor. The contracting officer accepted the contractor's argument that raw material prices, received 8 days prior to certification, could not be made available to the government. Also, the contracting officer reduced the price adjustment to about $5 million by using a different baseline. Extensive negotiations followed, with the contracting officer, DCAA, and contractor personnel meeting on five separate occasions from October 1989 to April 1990. A settlement was reached in December 1990, over 4 years after the initial audit report, when the contracting officer accepted the contractor's offer for a little over $5 million.

Even cases that appear relatively simple involve audit, review, and response burdens and can take years to settle. For example, settling a $3.1-million overpricing action that was reported by the contractor took over 3-1/2 years from the date reported by the contractor. The contractor's internal auditors found that a "bottoms up costing report" prepared on August 28, 1984, was not disclosed to government negotiators prior to or during the negotiations. On February 11, 1988, the contractor submitted the internal audit report with a recommended price adjustment of $3.2 million to the Air Force and DCAA for consideration. DCAA issued its report, which recommended a $3.1-million price adjustment, on September 25, 1990; however, the contracting officer did not make the $3.1-million adjustment to the contract until July 26, 1991.

Management System Contains Reporting Errors

The data in DOD's contract audit follow-up management system on defective pricing settlements are unreliable because of weak internal controls. Accordingly, the data in the system contain reporting errors, and these errors raise questions about DOD's reported sustention rate for defective pricing. DOD has initiated some corrective actions, but it will be some time before their effectiveness can be determined.

We found numerous reporting errors in costs questioned and amounts sustained in contract audit settlements that we selected from the follow-up system. After eliminating identified errors, the sustention rate for our cases was 29 percent, significantly below the 40-percent sustention rate reported for the same cases in the contract audit follow-up system. Table 4.1 compares the sustention rate reported in the follow-up system for our selected cases with the amounts we documented.

Table 4.1: Sustention Rate Reported in DOD Follow-up System Compared With Documented Amounts

Dollars in millions; rates in percent

Data from	Cost questioned	Cost sustained	Sustention rate
Follow-up system	$111.9	$44.8	40
Source documents	138.3	40.0	29

The difference in sustention rates was caused by the services and defense agencies reporting incorrect data. We found audits that were reported closed but had not been settled, interest charges that were reported as costs sustained, and other errors of significant amounts. Such errors raise questions about the amount of defective pricing being pursued as well as the amount sustained and call into question the validity of statistics reported to the Congress. Since our selected cases are not a statistical sample, we cannot project an overall sustention rate for fiscal year 1991.

As previously discussed, the October 1990 DOD IG report found similar problems with the accuracy of data being reported by acquisition activities in the follow-up system. In its evaluation of closed contract audit reports in the follow-up system during fiscal years 1987 and 1988, DOD IG found that more than half of the amounts reported as questioned or sustained costs were incorrect, and the frequency of the reporting errors made the data in the system unreliable, although the errors' effect on sustention rates was minimal. It reported that the cause of the problem was a widespread lack of internal controls at the contracting and contract administration activities to ensure accurate reporting.

DOD IG recommended specific corrective actions at each contracting activity reviewed. Overall, DOD IG recommended that activities should (1) ensure that personnel responsible for reporting data are trained and know the system, (2) maintain a centralized tracking system, preferably automated, and (3) review and check for reporting errors.

In a June 1990 report on DCAA's compliance with contract audit follow-up policy, DOD IG noted that summary sheets and control logs, which are used by contracting activities and other DOD components to account for all defective pricing audit reports, were not always correct. The review found that about 20 percent of the contract audit reports were incorrectly reported to contracting or contract administration activities and that only 80 percent of the audits were reported. This resulted in the control logs being inaccurate and unreliable. DCAA did not report 47 percent of its contract audits in the control logs, and 12 percent of the entries in the control logs were incorrect.

A follow-on examination by DCAA found control logs were inaccurate and only included about half of the audit reports issued during the period. The follow-on review, which was completed in January 1991, confirmed that the problems noted by DOD IG still existed. Several recommendations were proposed and actions to correct deficiencies initiated.

We were told by DOD officials that the contract audit follow-up reporting system and DCAA's input data are being automated. They said that the project is expected to be completed in December 1993 and that automating the system will expedite the reconciliation between DCAA-issued reports and the reports outstanding in the contract audit follow-up system. However, other internal control problems, such as data not being verified by acquisition activities, would not be corrected. DOD officials said that some acquisition activities have been directed to improve their review procedures to eliminate reporting errors.

Data on Contract Audit Settlements Inadequate

The data reported in DOD's contract audit follow-up system are not an effective management tool for administering the settlement process. The system does not identify the amount that is recovered by the government, including interest and penalty; information on sustention rates that is developed from the system is of limited use to DOD; and accountability for low sustention rates is not addressed.

Amount Recovered Is Not Identified

The cost sustained amounts reported by DOD are not the amounts the government recovers through contract modifications or refunds. Some of the contracts audited by DCAA for defective pricing are incentive contracts in which the government and the contractor share cost overruns and underruns from a "target price." The system only recognizes the effect defective pricing has on the target price. It does not recognize the government's share of the cost. For example, in one of our selected cases, DOD reported $5.2 million as the amount sustained, but the reduction to the contract was only $2.4 million.

No Provisions for Interest or Penalty Reporting

The contract audit follow-up policy also does not specify how interest charges or penalties should be reported in the system. Interest was treated differently in the follow-up system by DOD acquisition activities in our selected cases. In one case, $93,064 in interest was included in the cost sustained amount, thereby increasing the sustention rate. In another case, $365,850 in interest was not reported in the system. Because the follow-up

system does not specifically report data on interest or penalty collection, activities may continue to report this information in an inconsistent manner and reliable, aggregate data on interest and penalties will not be available.

Sustention Rate of Limited Use

The sustention rate provides very little information on the settlement process and is not a useful performance measure. DOD's reported sustention rate is only the percentage of DCAA's recommended price adjustment sustained for the reporting period. As part of its oversight responsibility for contract audit follow-up, DOD IG calculates sustention rates for DOD and contracting activities. For the period ending March 31, 1991, as an example, the overall sustention rate for DOD was 44 percent, with the Air Force having the highest rate at 55 percent and the Defense Logistic Agency having the lowest rate at 13 percent. In the second half of fiscal year 1991, the overall sustention rate was 38 percent. The Navy was high with 42 percent, while the Army was low with 26 percent. In addition, DOD IG compares the rate changes between reporting periods to identify fluctuations. Although DOD does not have a sustention rate performance goal, DOD IG may ask acquisition activities to review the contract audit follow-up system if the sustention rate declines significantly.

The system does not provide data on the percentage of (1) questioned costs from a specific year that are sustained in each succeeding year or (2) audits from a specific year that are settled in each succeeding year. Without such data, the system cannot provide meaningful measures of changes that are occurring within the settlement process. For example, the aggregate sustention rate will not measure the effects of DCAA's increased emphasis on quality audit reports that fully support defective pricing.

Also, the system does not identify the basis for the settlement or its impact on sustention rates. We found settlements, such as those by the Department of Justice or voluntary contractor disclosure, increased DOD's sustention rate. For example, four of the settlements we selected from the follow-up system were settled by the Department of Justice under false claims statutes. These statutes have remedies and penalties more severe than those under the Truth in Negotiations Act if the contractor is found guilty. In these cases, contractors agreed to the settlement, but only if the agreement did not constitute an admission of guilt. The Department of Justice was able to sustain more of the recommended price adjustment and in one case recovered an amount higher than the recommended price adjustment. In that case, the recommended price adjustment by DCAA was

$4.3 million, but the recovery was $7.5 million. The amount reported as cost questioned and cost sustained in the follow-up system was $7.5 million, a 100-percent sustention rate.

Two other cases that we reviewed were the result of contractors voluntarily disclosing defective pricing. If a contractor, because of an internal audit or management review, reports defective pricing, DCAA reviews the case and verifies the facts. This type of review was reported in the follow-up system as though it were a DCAA defective pricing contract audit and a usual contracting officer settlement. In the two cases that originated from voluntary disclosures, sustention was much higher than DOD's overall rate.

Accountability Is Not Addressed

Although DOD's policy on contract audit follow-up establishes specific responsibilities, accountability is not addressed in the system. DOD policy requires contracting officers and acquisition management officials to pursue proper settlement of recommended price adjustments. It even notes that performance appraisals of appropriate acquisition officials should reflect their effectiveness in settling audit findings and recommendations in a timely manner, while fully protecting the government's interest. However, the follow-up system does not identify the cause for not sustaining DCAA's recommended price adjustments. While additional data collection would be necessary to identify causes, DOD would be better able to determine the extent that low sustention rates results from such factors as poor quality audit reports, inadequate government evidence, or negotiating actions by contracting officers. With this information being reported in the management system, DOD could respond to sustention rate changes in a more timely manner with training, regulations, or internal controls.

Recommendation

The contract audit follow-up system should provide the information needed to support an effective settlement process. The system could be improved by (1) collecting such data as interest collected, penalties assessed, and causes for not sustaining recommended defective pricing from audits; (2) adding performance measures; and (3) establishing accountability. Effective utilization of the deterrent features of the act requires a system that provides accurate as well as comprehensive data for management assessments and actions. Therefore, we recommend the Secretary of Defense ensure that the audit follow-up system contains the data needed for oversight and management of the settlement process and

that ongoing improvements to internal controls place high priority on providing complete and accurate data.

Agency Comments and Our Evaluation

DOD agreed with the need for improvements in the contract audit follow-up system, but not with some of our specific suggestions for improvement. DOD agreed that the system contains too many errors. It noted that ongoing improvements to internal controls place a high priority on providing complete and accurate data and that the military services and DCAA are devoting more attention to data verification. DOD commented that it would continue to review the accuracy and completeness of data in the audit follow-up system and make whatever changes are necessary to ensure data integrity.

DOD stated that the contract audit follow-up system met the requirements of the Office of Management and Budget Circular A-50 and its own implementing instruction and did not agree that the system is inadequate for administering settlements of defective pricing audits. However, DOD agreed to review the system to determine if there is a practical and economical way to compile and report on interest and penalties collected for defective pricing settlements. DOD commented that the other data, which we suggested would improve oversight, management, and accountability, would not add any value, but would impose additional administrative complexities.

DOD's actions to ensure data integrity in the follow-up system and to explore, including interest and penalties collected in the system, respond to our recommendation. We continue to believe that other data and system changes could provide more effective management of the settlement process without imposing excessive administrative burdens. For example, DOD agrees that gross sustention rates are not very meaningful. Our suggestion for refinements in the reporting of the sustention rate, which would provide improved measures of change within the settlement process, would essentially involve only additional analysis of available data, not the collection of additional data.

Comments From the Department of Defense

OFFICE OF THE UNDER SECRETARY OF DEFENSE

WASHINGTON, DC 20301-3000

ACQUISITION

SEP 0 3 1993

DP/CPF

Mr. Frank C. Conahan
Assistant Comptroller General
National Security and International
Affairs Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report entitled--"CONTRACT PRICING: DoD's Use of the Truth in Negotiations Act Deterrents Could Be Increased," dated July 16, 1993 (GAO Code 396303/OSD Case 9371). The Department generally concurs with the report.

Since 1987, the DoD has made substantial efforts to reduce the incidence of defective pricing in its contracts. Based on recommendations made by the GAO, the Department required contractors to have estimating systems that consistently produce well-supported and documented proposals, published a list of the characteristics of an adequate estimating system, and required that estimating systems be reviewed periodically. The Defense Contract Audit Agency significantly increased the audit resources devoted to defective pricing and estimating system reviews. The DoD initiated the Contractor Risk Assessment Guide program to encourage contractors to develop and implement better internal control systems for high risk areas, such as estimating systems, and many contractors are participating in the program. Additionally, in response to numerous reports issued during the last five years by the GAO and the DoD Inspector General, many other actions have been taken to improve estimating systems and reduce defective pricing.

The cited DoD actions have had a positive effect. The most recent statistics reported by the GAO indicate there has been a dramatic reduction in defective pricing. From Fiscal Year 1990 to Fiscal Year 1992, the amount of defective pricing found by the Defense Contract Audit Agency dropped 84 percent, from $922 million to $148 million. While the DoD is pleased with those results, the Department agrees with the GAO recommendations that additional

actions need to be taken to ensure compliance with the interest and penalty provisions of the Truth in Negotiations Act, and to ensure the contract audit followup system contains accurate and complete data that meets the needs of management.

The detailed DoD comments on the report findings and recommendations are provided in the enclosure. The Department appreciates the opportunity to comment on the draft report.

Sincerely,

Eleanor Spector

Eleanor R. Spector
Director, Defense Procurement

Enclosure

GAO DRAFT REPORT--DATED JULY 16, 1993
(GAO CODE 396303) OSD CASE 9371

"CONTRACT PRICING: DOD'S USE OF THE TRUTH IN NEGOTIATIONS ACT DETERRENTS COULD BE INCREASED"

DEPARTMENT OF DEFENSE COMMENTS

* * * * *

FINDINGS

Now on p. 2 and pp. 8-9.

FINDING A: **The Truth in Negotiations Act--Recovery of Defective Pricing**. The GAO observed that the Truth in Negotiations Act (10 U.S. Code 2306a) mandates that--in the absence of adequate price competition--prime contractors and subcontractors must provide cost or pricing data when negotiating for contracts. The GAO further observed that contractors and subcontractors are required to certify that the cost or pricing data provided is accurate, current, and complete at the time of price agreement with the Government. The GAO pointed out that, if the data are found to be defective, the Government can reduce the contract price.

Although the Act has been instrumental in providing data needed to negotiate contracts, the GAO found defective pricing continued to be a persistent problem that adds hundreds of millions of dollars to contract prices each year. The GAO pointed out that, until 1985, recovery of defective pricing was the only deterrent feature of the Act. The GAO observed, however, that in response to reports of contractor abuses, the Congress added a penalty equal to the amount of overpayment--if the contractor knew the data was defective; and an interest charge on the amount overpaid from the date of overpayment to repayment. The GAO explained that oversight, management, and settlement of defective pricing responsibilities are shared within the DoD among the Defense Contract Audit Agency, the DoD acquisition and contract administration activities, and the DoD Inspector General. (pp. 2-3, pp. 9-11/GAO Draft Report)

DOD RESPONSE: Concur.

FINDING B: **Contract Audit Settlement Reporting**. The GAO reported that the DoD management tool for tracking and reporting on contract audit settlements is the audit followup system. The GAO observed that the followup system tracks individual defective pricing audit reports by the Defense Contract Audit Agency report number. The GAO explained that the

ENCLOSURE

ow on pp. 9-10.

sustention rate for defective pricing audits is calculated from information in the followup system and is used in the management and oversight of the settlement process. The GAO found that, in addition to the contract audit followup system, the Defense Contract Audit Agency maintains an automated field office management information system for assignment management purposes. The GAO noted that the information is also included in the DoD Inspector General Semiannual Report to the Congress. (pp. 11-12/GAO Draft Report)

DOD RESPONSE: Concur.

FINDING C: Most Identified Defective Pricing Not Sustained. The GAO reported that, for the DoD audits settled in FY 1991, about 41 percent of the $227 million in price adjustments was sustained. The GAO observed that the sustention rate had declined since FY 1988. The GAO found that, in 1992, actions to improve the audits were implemented and some contracting activities initiated efforts to raise sustention rates. The GAO found that in the first half of FY 1993, the sustention rate increased to 58 percent. The GAO indicated the DoD had not determined whether that increase is attributable to the specific 1992 actions or is, in fact, an indicator of a longer term change in sustention rates. Concerning one specific action, the GAO found that, out of 1,000 reports reviewed by Defense Contract Audit Agency audit offices, reduced price adjustments were recommended in 146 reports for a total of $169 million. The GAO concluded that such reductions would result in higher sustention rates as the reports are settled. (pp. 15-16/GAO Draft Report)

ow on pp. 12-13.

DOD RESPONSE: Partially concur. Considering gross level sustention rates alone is not very meaningful of itself. The DoD examines individual actions to determine whether the amount of defective pricing sustained by contracting officers is reasonable. That is why the Office of the DoD Inspector General regularly reviews sustention rates for individual buying commands and examines individual actions with low sustention rates. The Inspector General's findings form the basis of recommendations for corrective actions made to local management, to Military Department management if necessary, and ultimately to the Office of the Secretary of Defense, if the DoD Inspector General is not satisfied with the results.

Recent programs initiated by the Military Services to establish dedicated settlement activities and increase management attention to individual actions where sustention rates are less than 50 percent should improve sustention rates. Additionally, steps taken by the Defense Contract Audit Agency to improve communications with contracting officers and contractors, and to increase fact finding before issuing audit reports, should result in better documented defective pricing recommendations and contribute to higher sustention rates.

The GAO noted that the Defense Contract Audit Agency took one specific action to revisit unsettled defective pricing reports in 1992. That effort was one of many actions that the Agency has taken during the past three years. For example, in 1990 and 1992, top management from the Defense Contract Audit Agency visited major buying commands to identify causes for low sustention rates and to address the concerns of contracting officers. Acquisition officials and contracting officers offered some good suggestions on how the Defense Contract Audit Agency could improve its services and the Agency has taken steps to address their concerns.

Now on pp. 13-14.

FINDING D: Audit Errors, Inconclusive Evidence, and Lack of Reliance Lower Sustention Rate. The GAO found that, of the 67 audit report settlements it reviewed, 29 were closed (1) with no amount sustained—or (2) the amount was reduced because the contracting officer determined that the Defense Contract Audit Agency audit report was in error or the facts did not conclusively support the recommended price adjustment. The GAO further found that audit reports were also dismissed because contracting officers did not rely on the defective data during contract negotiations. The GAO concluded that recommended price adjustments were often not sustained. (pp. 16-18/GAO Draft Report)

DOD RESPONSE: Partially concur. The GAO noted that, based on its own reviews of audit reports and contracting officer determinations, the Defense Contract Audit Agency determined deficiencies in its reports have contributed to low sustention rates. While the review by the Defense Contract Audit Agency identified some cases where postaward audit reports did not adequately explain the criteria used for establishing defective pricing, the primary finding was that price negotiation memoranda often did not include all the information needed to perform a defective pricing review. The Defense Contract Audit Agency, therefore, instructed its auditors to obtain input directly from the contracting officer and the contractor prior to issuing an audit report, rather than relying solely on information provided in price negotiation memoranda. Because of the nature of the problem, the Defense Contract Audit Agency also revisited all unsettled reports to coordinate with contracting officers and contractors to ensure the reports considered all available facts.

FINDING E: Inappropriate Determinations Lower Sustention Rates. The GAO identified several contracting officer determinations that appeared inappropriate because the Defense Contract Audit Agency recommended price adjustments were reduced or eliminated without an apparent valid basis. The GAO noted that, in one case, the contractor proposed to buy equipment at an estimated cost of $2.5 million, but had, instead, developed a $1.3 million estimate to make the item in-house. The GAO found that the contracting officer dismissed the price adjustment

because the audit did not provide evidence to support that the contractor, at the time of the price agreement, had decided to make, rather than buy the equipment. The GAO concluded that the determination was questionable, because the Act requires contractors to disclose all cost and pricing data that would reasonably be expected to significantly affect price negotiations. The GAO further concluded that the difference in the two estimates is significant and disclosure of the estimate to make the item in-house could have influenced the negotiation and the price. (pp. 19-20/GAO Draft Report)

Now on pp. 14-15.

DOD RESPONSE: Concur. Based on the facts presented in the GAO report, the determinations made by the Air Force may be inappropriate. However, defective pricing cases are often complex and involve significant legal issues. The information presented by the GAO is not sufficient for the DoD to determine the appropriateness of the determinations.

FINDING F: **Negotiated Settlements Also Lower Rate**. The GAO concluded that another reason contributing to the low sustention rate was that contracting officers negotiated with contractors to reach what they believed were *fair and reasonable settlements*. The GAO found that, in the cases it reviewed where the Government recovered defective pricing, contracting officers usually negotiated settlements that were lower than the Defense Contract Audit Agency recommended price adjustment. And even though the Government is entitled to a price adjustment for the full amount of the pricing defect, as determined by the contracting officer, the GAO further found that, in some cases, contracting officers negotiated for a lesser adjustment to avoid possible litigation. (pp. 20-21/GAO Draft Report.)

Now on pp. 15-17.

DOD RESPONSE: Partially concur. Defective pricing audits with recommended price adjustments are *only* advisory. The Office of the DoD Inspector General in its October 1990 Report on Nonsustention of Questioned Costs (Report No. AFU-91-1) stated that contracting officer resolution and disposition actions were generally reasonable. The report pointed out that there are many reasons for non-recovery of auditor recommended price adjustments. For example, legal counsel may have advised that the litigation risk involved in taking the case to a full hearing was such that a negotiated settlement would be in the best interest of the Government. The experience of the Air Force Materiel Command has been that sustention rates for litigated cases are significantly lower than those settled by negotiation. Accordingly, contracting officers, with the assistance of legal counsel, must weigh the risks and benefits of litigation to determine whether or not a negotiated settlement is in the best interest of the Government. Additionally, defective pricing cases are often complex with many "gray"

areas that require the use of judgment, and contracting officers must have sufficient latitude to make prudent business decisions in those cases.

FINDING G: Causes for Nonsustention Identified by the DoD Inspector General. The GAO acknowledged that the causes it had identified for the Defense Contract Audit Agency recommended price adjustments not being sustained were similar to those identified by the Office of the DoD Inspector General in the October 1990 Report on Nonsustention of Questioned Costs (Report No. AFU-91-1). The GAO pointed out, however, that even though the DoD Inspector General concluded the amounts were reasonable, it did not mean the rate could not be improved upon--as the DoD Inspector General recommended. (pp. 22-23/GAO Draft Report)

Now on pp. 17-18.

DOD RESPONSE: Partially concur. The manner in which the GAO characterized the causes for nonsustention creates the impression that the number one cause was that audit reports contained inaccurate or outdated information. That interpretation is incorrect, since the October 1990 report found that to be the cause for only 10 percent of the reports and other causes were found more frequently.

The Air Force reviews defective pricing cases where sustention rates are less than 50 percent of costs questioned or where the amount of difference between costs questioned and sustained is greater than $1 million. Through that process, the Air Force can identify potential problem areas that may require correction through additional training or policy guidance.

FINDING H: Interest and Penalty Provisions Enacted to Deter Contractor Offenses. The GAO observed that, prior to the Congress adding interest and penalty provisions to the original legislation of the Truth in Negotiations Act, contractors had little incentive to (1) submit accurate, complete, and current data and/or (2) expedite settlement. The GAO also pointed out that no penalty had existed for overpricing, and interest accrued only if the overpayment was not paid within 30 days from a Government request for payment. The GAO concluded that, under the original legislation, contractors who received overpayments because of defective data had long term use of Government funds and paid no interest. (pp. 24-25/GAO Draft Report)

Now on pp. 19-20.

DOD RESPONSE: Concur.

FINDING I: Full Amount of Interest Not Collected. The GAO concluded that the DoD could recover more interest on overpayments. The GAO found, however, that the DoD guidance does not provide for collection of the maximum interest--and contracting officers, acting without specific

Now on pp. 20-22.

authority, have not charged part or all the interest due on overpayments. The GAO further found that the DoD regulations also provide no guidance on assessing the penalty and could not find any instance where the penalty had actually been assessed. The GAO further concluded, therefore, that when a contract is defectively priced and the DoD does not effectively use the provisions of the Act, the deterrent effect is diminished.

In addition, the GAO found that DoD regulations do not provide for the full collection of interest and prohibit interest recovery for amounts paid for contract financing. The GAO did agree that, in some instances, adding interest to an overpayment occurring in progress payments might not be significant and could be an administrative burden. The GAO asserted, however, that in other cases interest on overpayments occurring in progress payments could be significant and interest determinations might not be a costly administrative burden. The GAO also emphasized that there is significant defecting pricing in subcontracts. (pp. 25-29/GAO Draft Report)

DOD RESPONSE: Concur. The Department concurs that there may be instances where the DoD could collect more interest and that the DoD regulations do not include collecting interest on progress payments. Federal Acquisition Regulation 15.804-7(b)(7)(ii)(B) states that interest shall be calculated from the date payment was made for the related completed and accepted contract items. Overpayment generally occurs only when payment is made for supplies or services accepted by the Government, i.e., when profit or fee is paid. Thus, progress payments typically would not be affected by overpricing due to defective cost or pricing data.

FINDING J: Penalty Provision Had Not Been Used. The GAO found no evidence that the penalty provision in the Truth in Negotiation Act has been used by contracting officers. The GAO also found that the penalty under the Act is not being used, apparently because contracting officers view a penalty for a knowing submission of defective data as civil or criminal fraud—which is to be pursued by the Department of Justice. The GAO explained that under the False Claims Act, any person who knowingly presents false information to the Government for payment or approval is liable for an administrative penalty and three times the amount of the damage. The GAO noted that the Department of Justice resolved five of the defective pricing cases reviewed by the GAO after initiating action under the False Claims Act. In summary, the GAO concluded, therefore, that (1) the need for a deterrent still remains, (2) the risk of defective pricing still exists, and (3) the contractors still do not comply with the Act.

The GAO indicated that, for FY 1992, the Defense Contract Audit Agency assessed defective pricing risk based on four factors—(1) estimating

Now on p. 4 and pp. 22-24.

system deficiencies, (2) accounting system deficiencies, (3) incidence of defective pricing, and (4) amount of recommended price adjustments. The GAO concluded that defective pricing involving billions of dollars has been a persistent problem with a few contractors not complying with the Act. The GAO explained that, for FY 1987 through FY 1991, 116 contractors accounted for 86 percent of the defective pricing reported by the Defense Contract Audit Agency. (p. 4, pp. 29-31/GAO Draft Report)

DOD RESPONSE: Partially concur. The Federal Acquisition Regulation includes a discussion of the Government entitlement to penalties and a clause that provides for assessment of a penalty equal to the amount of the overpayment, if the contractor or subcontractor knowingly submitted incomplete, inaccurate, or noncurrent cost or pricing data. However, if the contracting officer or auditor believes a contractor knowingly submitted defective cost or pricing data, the regulations specify that the contracting officer shall obtain the advice of counsel before taking any contractual actions concerning penalties. If counsel agrees, the case is usually referred to the Defense Criminal Investigative Service as false claims/false statements.

FINDING E: Many of the Settlements Are Not Timely and The Process Is Burdensome. The GAO reported that, although the DoD regulations state that audits should be settled in a timely manner, only half of the audits closed in FY 1991 were settled within one year of the audit report date. The GAO pointed out that many of the other settlements took from two to four years--with some taking longer. The GAO noted that because settlements often require several reports, the period is significantly increased if measured from the first audit report.

In addition, the GAO found the settlement documents show that contracting activities and contractors encounter administrative burdens throughout the settlement process. The GAO noted that in the selected cases it reviewed, most of the settlements involved several audits and responses by contractors--as well as meetings to resolve issues and reach agreements. (p. 5, pp. 35-37/GAO Draft Report)

Now on p. 4 and pp. 26-29.

DOD RESPONSE: Concur. Some settlements can become extended because of the administrative and judicial processes available to contractors. As the GAO noted in its report, "Even cases that appear relatively simple involve audit, review, and response burdens and can take years to settle." It should also be recognized, however, that during 1991, 52 percent of defective pricing audits were settled within one year from issue date.

FINDING I: Management System Information Contains Reporting Errors. The GAO concluded that reporting errors caused by weak internal controls

have made the data in the system unreliable and raise questions about the DoD reported sustention rate for defective pricing. The GAO noted that the DoD had initiated some corrective actions, but concluded it will be some time before the effectiveness of those actions can be determined. The GAO also pointed out that management data--such as the amount recovered from a contractor, interest charged, penalty assessed, or cause for nonsustention--are not collected in the system.

The GAO found numerous reporting errors in costs questioned and amounts sustained in contract audit settlements that were selected for review from the followup system. The GAO calculated that, after eliminating identified errors, the sustention rate for the reviewed cases was 29 percent--which was significantly below the 40 percent sustention rate reported for the same cases in the contract audit followup system. The GAO further concluded that the difference in the sustention rates was caused by the Military Services and the Defense Agencies reporting incorrect data. The GAO found audits that were reported closed, but had not been settled, interest charges reported as costs sustained, and other errors of significant amounts.

The GAO pointed out the DoD Inspector General had also reported that the contract audit followup system lacked internal controls needed to ensure accurate reporting. The GAO explained that the Contract Audit Followup reporting system and the Defense Contract Audit Agency input data are being automated, with the project expected to be completed by December 1993. The GAO concluded, however, that other internal control problems--such as data not being verified by acquisition activities--would not be corrected by the automation. The GAO was advised that at least some acquisition activities have been directed to improve review procedures to eliminate reporting errors. (p. 6, pp. 37-39/GAO Draft Report)

Now on p. 4 and pp. 29-31.

DOD RESPONSE: Concur. The Department agrees there are too many errors in the Contract Audit Followup reporting system. Both the Military Services and the Defense Contract Audit Agency are making refinements to their automated systems and devoting more attention to verification of data to increase accuracy. Additionally, the Office of the DoD Inspector General regularly analyzes contract audit followup report data, conducts regular contract audit followup reviews at the contracting activity to verify the accuracy of reporting, and provides information to management on corrections needed.

FINDING M: Data on Contract Audit Settlements Inadequate. The GAO concluded that the data reported in the DoD contract audit followup system is not an effective management tool for administering the settlement process for the following reasons:

- **Amount Recovered Is Not Identified**--The GAO found that the cost sustained amounts reported by the DoD are not the amounts the Government recovers through contract modifications or refunds. The GAO noted that the system only recognizes the effect defective pricing has on the target price--it does not recognize the Government share of the cost.

- **No Provisions for Interest or Penalty Reporting**--The GAO found that the contract audit followup policy does not specify how interest charges or penalties should be reported in the system. The GAO concluded that activities may continue to report the information in an inconsistent manner and, therefore, reliable, aggregate data on interest and penalties will not be available.

- **Sustention Rate of Limited Use**--The GAO also concluded that the sustention rate provides very little information on the settlement process and is not a useful performance measure. The GAO reported that the DoD Inspector General compares the rate changes between reporting periods to identify fluctuations. The GAO further reported that, although the DoD does not have a sustention rate performance goal, the DoD Inspector General may ask acquisition activities to review the contract audit followup system if the sustention rate declines significantly. The GAO concluded, however, that without data on the percentage of questioned costs from a specific year, which are sustained in each succeeding year--or audits from a specific year that are settled in each succeeding year, the system cannot provide meaningful measures of changes that are occurring within the settlement process.

- **Accountability Is Not Addressed**--The GAO concluded that, although the DoD policy on contract audit followup establishes specific responsibilities, accountability is not addressed in the system. The GAO further concluded that, if the followup system identified the cause for not sustaining the Defense Contract Audit Agency recommended price adjustments, the DoD would be better able to determine the extent that low sustention rates result from factors such as (1) poor quality audit reports, (2) inadequate Government evidence, or (3) negotiating actions by contracting officers. In summary, the GAO concluded that, if such information were in the management system, the DoD could respond to sustention rate changes in a more timely manner with training, regulations, or internal controls. (p. 6, pp. 40-43/GAO Draft Report)

Now on p. 4 and pp. 31-33.

DOD RESPONSE: Nonconcur. The Department does not agree the DoD contract audit followup management system is inadequate for administering settlements of defective pricing audits. Office of Management and Budget Circular A-50, "Audit Followup," dated September 29, 1982, as implemented in the DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports," defines management officials'

responsibilities relating to post award contract audit findings and recommendations and requires systems that provide records of action taken on both monetary and nonmonetary findings and recommendations.

The Circular A-50 policy applies to all types of post award audits, not just defective pricing, and does not require the break out of the Government share of costs sustained for specific types of contracts or specific types of audits. The Government contracting officer must resolve the audit recommendations in accordance with the Circular A-50 policy no matter how the share breaks out. Circular A-50 was issued to ensure post award contract audits are "worked" no matter who benefits, whether it be a contractor with an audited claim against the Government or a Government contracting officer seeking recovery from a contractor as a result of a defective pricing claim.

The DoD will review the systems currently in place to determine if there is a practical and economical way to collect and report on interest and penalties collected for defective pricing audits. (See the DoD response to Recommendation 2.) It should be recognized, however, that neither Circular A-50, nor the Truth in Negotiations Act amendment, require the reporting of interest or penalties. Further, the Inspector General Act does not require such reporting; a review of semiannual reports for six major departments found no such reporting and made no distinction as to the Government share of sustained costs on incentive type contracts.

The Department does not agree that the followup system cannot provide meaningful measures of changes that are occurring within the settlement process, and that measures should be made from data showing the percentage of (1) questioned costs from a specific year that are sustained in each succeeding year or (2) audits from a specific year that are settled in each succeeding year. The data suggested by the GAO would not add any value to the efficient management of the process, but would impose additional administrative complexities. The primary driver of sustained costs are the conditions that exist at the time the price adjustment is negotiated, not the year the audit report was issued. As demonstrated over the past several years, the current system was used to identify audits with low sustention rates so that root causes of nonsustentions could be addressed. This enabled the Defense Contract Audit Agency to take action on those causes; segregating actions by year of audit would not have enhanced the evaluation. Also, whenever a significant change in the law, regulation, or process takes place that affects the negotiation of open audits, supplemental reports would be issued so the negotiator has sufficient evidential data. The revisit of open audit reports by the Defense Contract Audit Agency in 1992 was necessary once it learned that the review of price negotiation memorandums alone did not always provide necessary facts, and that additional coordination was necessary. Therefore, all open assignments, regardless of the year of audit, benefited from the enhanced guidance.

The Department disagrees that accountability is not addressed in the audit followup system. The file documentation for defective pricing cases contains all necessary data to determine reasons for nonsustention. The files are regularly reviewed by the Office of the DoD Inspector General to determine the causes of nonsustention and if there are systemic difficulties that require correction. Additionally, audit followup system procedures require the contracting officer to provide a copy of the price negotiation memorandum documenting the disposition of the audit recommendations to the auditor. Auditors review those documents to determine if changes are required in audit techniques and reporting.

In addition, the DoD Directive 7640.2 and the Military Services and Defense Logistics Agency implementation require that performance appraisals of appropriate acquisition officials reflect their effectiveness in resolving and dispositioning audit findings and recommendations in a timely manner, while fully protecting the interest of the Government. The Office of the DoD Inspector General reports to higher level management when noncompliance with that policy is found at acquisition activities they review. The Office of the DoD Inspector General has also identified the need for contract audit followup training at a number of sites during the last two years and has even conducted such training during their reviews. On site review of contract audit file documentation by the Office of the DoD Inspector General and interviews conducted with contracting officers and auditors identify the factors contributing to low sustention rates, not the semiannual reports required by DoD Directive 7640.2.

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RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense more effectively implement the interest and penalty features of the Truth in Negotiations Act to assure contractor compliance. The GAO further recommended that the Secretary could include the following actions:

- based on an analysis of appropriate defective pricing audit reports--determine whether charging interest on overpayments in progress payments resulting from defective pricing is administratively feasible and would result in significant interest recovery, and if so, initiate action to revise the regulation;

- direct contracting activities to instruct contracting officers to charge interest as stipulated in the regulations, and to include internal control checks for proper interest charges during business clearance reviews; and

Now on p. 5 and p. 24.

- modify the DoD guidance to instruct contracting officers on the use of the penalty in determining the amount recoverable from contractors for defective pricing to ensure that the penalty becomes a useful deterrent. (p. 6, pp. 31-32/GAO Draft Report)

DOD RESPONSE: Partially concur. By March 1994, the Defense Contract Audit Agency will conduct a study of five large prime contracts for which defective pricing has been reported and progress payments are being made. If overpayments have occurred in progress payments resulting from defective pricing, the Defense Contract Audit Agency will determine the amount of interest that should be assessed. The Department will then consider the significance of the interest amount assessed and whether charging interest is administratively feasible.

By October 1993, the Department will direct contracting activities to instruct contracting officers to charge interest as stipulated in the regulations, and to include internal control checks for proper interest charges during business clearance reviews.

By October 1993, the Department will also ask the Office of General Counsel to review current regulations on the assessment of penalties for the knowing submission of defective cost or pricing data. Based on that review, the DoD will determine if additional guidance is appropriate.

Now on p. 5 and pp. 33-34.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense ensure (a) that the contract audit followup system contains the data needed for the oversight and management of the settlement process and (b) that ongoing improvements to internal controls place high priority on providing complete and accurate data. The GAO further recommended that the audit followup system could be improved by (1) collecting data such as interest collected, penalties assessed, and causes for not sustaining recommended defective pricing, (2) adding performance measures, and (3) establishing accountability. (p. 6, p. 43/GAO Draft Report)

DOD RESPONSE: Partially concur. The Department agrees with the general improvements recommended by the GAO, but not with the specific suggestions for improvement. Ongoing improvements to internal controls already place a high priority on providing complete and accurate data. The Military Services and the Defense Contract Audit Agency are making refinements to their systems and data bases, and are devoting more attention to verification of data in order to improve accuracy and provide DoD managers with more reliable information on the status of individual audit reports. Also, the Office of the DoD Inspector General regularly analyzes sustention rates for individual buying commands and examines individual actions with low sustention rates to determine the causes. Additionally, the Inspector General reviews performance plans of contracting officers to ensure compliance with the DoD Directive

7640.2, "Policy for Followup on Contract Audit Reports." The Inspector General findings form the basis of recommendations for corrective actions made to local management, to Military Department management, or to the Office of the Secretary of Defense. The Department will continue to review the accuracy and completeness of data in the audit followup system and make whatever changes may be necessary to ensure data integrity. In addition, by March 1994, the DoD will review the systems currently in place to determine the most practical and economical way to collect and report on interest and penalties collected for defective pricing audits.

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